Nos. 92-1384 and 92-1839

In The
Supreme Court of the United States
October Term, 1993

BARCLAYS BANK PLC,

Petitioner,

v.

FRANCHISE TAX BOARD,
AN AGENCY OF THE STATE OF CALIFORNIA,

Respondent.

COLGATE-PALMOLIVE COMPANY,

Petitioner,

v.

FRANCHISE TAX BOARD
AN AGENCY OF THE STATE OF CALIFORNIA,

Respondent.

On Writ Of Certiorari To The Court Of Appeals Of The State Of California In And For The Third Appellate District

AMICUS CURIAE BRIEF OF MULTISTATE TAX COMMISSION IN SUPPORT OF RESPONDENT FRANCHISE TAX BOARD

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QUESTIONS PRESENTED

1. Whether California's application of worldwide combined reporting to determine the taxable income of domestic corporations with foreign parents, or foreign corporations with either foreign parents or foreign subsidiaries, is unconstitutional under the foreign Commerce Clause.

2. Whether California's application of worldwide combined reporting to determine the taxable income of domestic corporations with foreign parents, or foreign corporations with either foreign parents or foreign subsidiaries, intrudes into an inherently federal area and is pre-empted by the United States Constitution.

3. Whether California's application of worldwide combined reporting to determine the taxable income of domestic corporations with foreign parents, or foreign corporations with either foreign parents or foreign subsidiaries, is unconstitutional under the Commerce Clause where such application imposes discriminatory compliance burdens on such entities.

4. Whether California's system for compliance with worldwide combined reporting violates the Due Process Clause of the United States Constitution where compliance is not possible without undue cost and the system, to function, depends on discretionary relief provisions without constitutionally sufficient standards to guide application and prevent arbitrary enforcement.

QUESTIONS PRESENTED – Continued

In its *Amicus Curiae* Brief, the Multistate Tax Commission shall address only Questions 1 and 2 of the Questions Presented.[1]

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[1] The Multistate Tax Commission has received consent from all parties to file this brief and will file written confirmation of those consents with the Clerk of the Court.

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MISCELLANEOUS

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STATEMENT OF INTEREST OF AMICUS CURIAE MULTISTATE TAX COMMISSION

The Multistate Tax Commission ("MTC" or "Commission") is the official administrative agency of the Multistate Tax Compact ("Compact"). Currently, the Compact has been entered into by 19 states and the District of Columbia as full members; and 13 additional states have joined the Commission as associate members.[1] The stated purposes of the Compact are to:

1. Facilitate proper determination of State and local tax liability of multistate taxpayers, including the equitable apportionment of tax bases and settlement of apportionment disputes.

2. Promote uniformity or compatibility in significant components of tax systems.

3. Facilitate taxpayer convenience and compliance in the filing of tax returns and in other phases of tax administration.

4. Avoid duplicative taxation.

As reflected by these four basic principles, the Commission possesses vital and continuing interest in those state tax issues that may radically affect the administration of state tax systems. The pending cases have that potential. The issues contained in these two cases strike close to the core of one of the Commission's overall responsibilities – to ensure that state tax systems are allowed to innovate and develop more sophisticated methods of taxing business activities conducted within their jurisdictions, and to adapt those systems in response to evolving social and economic conditions.

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[1] The current full members are the states of Alabama, Alaska, Arkansas, California, Colorado, District of Columbia, Hawaii, Idaho, Kansas, Minnesota, Missouri, Michigan, Montana, New Mexico, North Dakota, Oregon, South Dakota, Texas, Utah, and Washington. The associate members are the states of Arizona, Connecticut, Georgia, Louisiana, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, Ohio, Pennsylvania, Tennessee and West Virginia. To the extent that any member state of the Commission files a separate brief in this case, this *amicus curiae* brief does not represent the position of said state or states in this case.

SUMMARY OF ARGUMENT

Petitioners seek to elevate the "squeaking" of foreign multinationals, the "bullying shouts" of a few foreign governments, and the occasional "whining" of a few ex-officials of the Executive branch to the federal government's "one voice". The Court is being asked to follow these voices, as if they were the calls of the Pied Piper. However, when all of the self-serving noise and clutter are filtered out, one clear message emerges: worldwide combined reporting (hereafter "WWCR") is consistent with and not in opposition to policies adopted by the federal government with respect to the state taxation of foreign commerce.

No need for a dormant foreign commerce clause analysis exists in the cases before the Court because the circumstances surrounding the Senate ratification of the U.S.-U.K. Tax Treaty demonstrate that both countries acquiesced to the states' uses of WWCR. In particular, the Senate's reservation to proposed Article 9(4) of the Treaty clearly establishes that California's WWCR does not violate the "one voice" prong of *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979). Since this aspect of the "one voice" issue has been extensively addressed in the Brief of Respondent, the Commission will not repeat it here, but will deal primarily with the dormant federal commerce clause issue that is reached if the Court hears voices other than those expressed by Respondent and its *amici*.

Worldwide combined reporting for state tax purposes greatly reduces the opportunity for tax planning and tax avoidance with regard to international business activities conducted by domestic or foreign-based taxpayers. WWCR addresses more effectively than any arm's length or separate accounting method the taxation of income derived by a unitary business from international transactions, regardless of their operating in or through the various tax havens. This method of accounting (which its detractors often intentionally mislabel a "tax") is a product of our federal system. It was conceived, developed and advanced by the states to maturity over the past 40 years or so. The teaching of *Garcia v. San Antonio Metropolitan Transit Authority*, 469 U.S. 528 (1985) suggests that it be left to

Congress to advance or limit the states' sovereignty in this area.

Even applying the test in *Japan Line*, WWCR should be upheld. More fundamentally, the *Japan Line* analysis is not appropriate in a global economy. To the extent that *Japan Line*'s rationale has survived subsequent decisions of the Court, it is clearly not properly applied outside the context of a tax, such as a property tax, for which no existing pattern or practice of eliminating double taxation exists. The Court's decisions in *Wardair Canada, Inc. v. Florida Dep't. of Revenue*, 477 U.S. 1 (1986) and *Itel Containers International Corp. v. Huddleston*, ___ U.S. ___, 113 S.Ct. 1095 (1993) have all but overruled key holdings of *Japan Line*.

At issue in both cases is the use of the same type of accounting method, worldwide combined reporting. While all of the arguments that are set forth by the Commission are specifically addressed to Petitioner Barclays, with no specific mention of Petitioner Colgate-Palmolive Co., a very critical relationship exists between the issues in the two pending cases. If this Court were to prohibit WWCR in the case of *Barclays*, then, as a political matter, state legislatures will find it nearly impossible to apply WWCR to U.S.-based multinationals. A decision in favor of Petitioner Barclays under the foreign commerce clause (U.S. CONST. ART. I, § 8, cl. 3) will be tantamount to overruling the result in *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983).

ARGUMENT

I. THE DORMANT FOREIGN COMMERCE CLAUSE DOES NOT PROHIBIT WORLDWIDE COMBINED REPORTING

A. The Dormant Foreign Commerce Clause Analysis Fashioned in *Japan Line* is Reminiscent of the Discredited *Cooley* Doctrine and is Unworkable.

The Court's dormant foreign clause analysis as formulated in *Japan Line* is reminiscent of the so-called *Cooley* doctrine, set forth in *Cooley v. Board of Wardens*, 53 U.S. (12 How.) 299 (1851). This similarity is not surprising because in both cases

the Court was struggling with the same issue: when does a state's action unconstitutionally impact on multijurisdictional economic activity. In *Cooley*, the Court held that the states could not regulate those aspects of interstate commerce that were so national in character that a single, uniform rule was necessary. *Id.* at 319. To paraphrase *Cooley* using the language of *Japan Line*, state regulations would be unconstitutional if they would "impair federal uniformity in an area where federal uniformity is essential." *Japan Line*, 441 U.S. at 448.

Over time, the *Cooley* doctrine proved unworkable for reasons that do not augur well for the Court's current formulation of dormant foreign commerce clause analysis. In the comparatively undeveloped U.S. economy of 1851, with a primitive transportation and communication infrastructure, there was less interdependency between the local and national economy. In this relatively uncomplicated era, the *Cooley* doctrine must have seemed manageable. As the country developed, however, the frequency of cross-border activities increased exponentially, and the line between local and interstate commerce became less distinct. Almost any state regulation had some impact on interstate commerce. The courts found it difficult, if not impossible, to determine which areas were, by their nature, inherently national.

According to a leading constitutional casebook, "the Court is not particularly well-suited for determining whether a given problem 'requires' a national solution as opposed to treatment tailored to local conditions,"[2] a sentiment that the Court itself has expressed in the context of the dormant foreign commerce clause. See *Container Corp. of America*, 463 U.S. 159, 194, 196. Because of the difficulty of identifying inherently national areas of interstate commerce, a subsequent doctrine, related to the *Cooley* doctrine developed. This doctrine required the Courts to distinguish between the constitutional "indirect" regulation of commerce and unconstitutional "direct" regulation.

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[2] DAVID CRUMP, ET AL., CASES AND MATERIALS ON CONSTITUTIONAL LAW 195 (1989).

That distinction was also criticized as being too mechanical and conclusory.[3]

Eventually, the earlier doctrines were discarded and "the tangled underbrush of past cases" was cleared. *Miller Bros. v. State of Maryland*, 347 U.S. 340, 344 (1954). The modern domestic dormant commerce clause analysis is now embodied in the four tests set forth in *Complete Auto Transit v. Brady*, 430 U.S. 274 (1974). In the domestic situation, a tax will be upheld if it: is applied to an activity with a substantial nexus with the taxing state; is fairly apportioned; does not discriminate against interstate commerce; and is fairly related to the services provided by the taxing state. *Id.* at 279. For purposes of the interstate commerce clause, *Complete Auto* abandoned any attempt to determine the need for federal uniformity or the need for the government to speak with one voice.

The same economic forces that undermined the *Cooley* doctrine and its progeny domestically are still at work internationally, undermining *Japan Line*. As the world's economies become more interdependent, state regulations and taxes now increasingly impact foreign commerce as well as interstate commerce. State corporate takeover legislation, plant closing laws, right to work laws, policies on resource extraction, governmental procurement preferences, environmental, product liability, and antitrust regulations have a global impact through interlinked trade and investment ties. Environmental issues such as acid rain or global warming demonstrate that the economic and social welfare of individuals in any political jurisdiction are inextricably linked to the actions and interests of individuals living elsewhere. For example, a state such as California that has adopted pollution control and automobile emission standards more stringent than federal law has an impact on cars manufactured all around the globe.

As the world of *Cooley* evolved into the global marketplace, the role of state and local government has also evolved. "[S]ubnational governments have traditionally served as valuable innovators and incubators of policy ideas in many

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[3] Gerald Gunther, Constitutional Law 242 (1985).

different fields. The central difference now is the extension of this function to the foreign policy arena. . . . "[4] National borders have now become as porous as state borders. All of the examples noted above raise possible violations of the dormant foreign commerce clause. To sort through the panoply of state laws to decide which ones impact on the need for national uniformity is to sink into the *Cooley* quagmire.

B. The Federal Government Does Not Speak with One Voice on the Issue of WWCR Nor Does the Federal Government Consider Such Uniformity Essential

1. No Weight Should be Given to Complaints of Foreign Governments About WWCR

Japan Line takes the position that a state taxing scheme violates the dormant foreign commerce clause if it impairs federal uniformity in an area where federal uniformity is essential and if it prevents the federal government from speaking with one voice in international trade. *Container*, 463 U.S. at 193. In support of their assertion that WWCR runs afoul of the "one voice" metaphor, Petitioners cite the complaints of other countries against WWCR. These complaints are simply evidence of the success of WWCR in controlling tax avoidance by foreign-based multinationals and should be given no weight in assessing the constitutionality of WWCR.

When multinational firms began operating extensively in California during the 1960's and early 1970's, the state faced

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[4] John M. Kline, United States' Federalism and Foreign Policy, in States and Provinces in the International Economy, eds., Douglas M. Brown and Earl H. Fry (1993), 225. As a another illustration of the world's linked destinies, the European Community was particularly concerned with California's 1990 debate over Proposition 128, which would have imposed limits on the pesticide content of food that differed from federal standards. The EEC sent an "aide memoire" to the U.S. State Department, expressing concern that Proposition 128 could be "a means of arbitrary discrimination or a disguised restriction on trade, thereby unjustifiably increasing fragmentation of the U.S. market and adversely affecting international trade." *Id.* 219-20.

two policy options. It could continue to apply formulary apportionment and combined reporting to unitary businesses operating domestically but switch to the federal system of separate entity accounting and source rules for unitary businesses operating internationally. Or it could apply its formula apportionment statute (including combined reporting for unitary businesses of multiple corporations) to California members of all unitary businesses, regardless of whether those businesses operated internationally and regardless of where they were incorporated. California chose the second option. As more worldwide businesses were attracted to California, the state's application of what became known as worldwide combined reporting naturally occurred more often and created more notice.

The second option was fully consistent with California's domestic approach. The same reasons that led California and many states to use formulary apportionment and combined reporting for unitary businesses operating domestically applied equally, if not more strongly, in an international setting. Formulary apportionment and combined reporting eliminate the opportunities to avoid tax through the use of transfer prices and tax havens – opportunities that are particularly serious in an international setting.[5] One of the premises of the California approach in the domestic setting was that the tax paid by a unitary business should not be a function of the way it is organized on paper; California had no good reason to reject that premise just because part of the unitary business was conducted abroad or just because a corporation filed its incorporation papers abroad. WWCR merely extends California's domestic approach, based on substance over form, across national boundaries.

To implement its system internationally in a world marked by tax havens and great diversity in taxing rules, the federal

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[5] Michael J. McIntyre, Design of a National Formulary Apportionment Tax System, in Proceedings of the Nat'l. Tax Ass'n/Tax Inst. of Am. 84th An. Conf. at 118 (November 1991).

government has had to develop source rules,[6] police transfer prices, and adopt anti-tax haven measures. The difficulties the IRS had, and continues to have, in policing transfer prices were well-known and it was doubtful that a state could independently administer an arm's length standard.[7] Subsequent events have borne out these fears.

Faced with these two choices, it is entirely understandable why California opted for WWCR. WWCR eliminates the need to police transfer prices, generally does away with source of income rules, and undercuts the use of tax havens. Tax planning that minimizes the federal income tax is typically useless under WWCR. Consequently, after WWCR was adopted, corporations able to pay no federal income tax now found themselves paying California tax, a situation that a foreign corporation or country not familiar with the federalist structure of the United States might not fully understand or appreciate.[8]

Certainly banks such as Barclays, with offices in some of the best-known tax havens of the world – Bahamas, Barbados, Bermuda, Cayman Islands, Channel Islands, Gibraltar, Hong

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[6] Source rules serve two distinct purposes. First, they serve a jurisdictional purpose in that foreigners are generally taxed on only U.S. source income. Second, they determine how much of a credit a U.S. taxpayer will receive for foreign income taxes imposed on foreign source income. For an exhaustive treatment, see Michael J. McIntyre, The International Income Tax Rules of the United States, ch. 4(1989).

All the attention focused on transfer pricing problems has overshadowed a major weakness in the federal system: the need to develop a set of workable source rules that can be easily administered, that can not be manipulated by the taxpayer, that reflect some acceptable notion about economic nexus, and that assign income to countries inclined to tax it. See *id.* at 3-66 - 3-70. Formulary apportionment greatly reduces the need for source rules.

[7] The practical impossibility for even the federal government of enforcing the arm's-length system is well illustrated by the I.R.S.'s recent loss of an effort to compel Chevron Corporation to label 1.3 million pages of documents it turned over to the government in a transfer pricing case. *Chevron Not Required to Label 1.3 Million Pages Turned Over to IRS*, 2 BNA Tax Management Transfer Pricing Report 135 (July 7, 1993).

[8] For an early example of where a U.K. corporation was able to pay no federal tax but nonetheless had to pay a state tax under formulary apportionment, see *Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n*, 266 U.S. 271 (1924).

Kong, Isle of Man, Nauru, Netherlands Antilles, New Hebrides, Singapore, Turks and Caicos, Virgin Islands[9] – have much of their international tax planning nullified under WWCR. Complaints about WWCR may be nothing more than a protest against an approach that minimizes the benefits of orthodox tax avoidance techniques such as the use of transfer pricing and tax havens and results in the payment of a state tax even where no federal tax is due. For example, Barclays Bank International, Ltd. owed a California tax even though its California operations were conducted at a loss under the taxpayer's arm's length calculations.[10]

Complaints from foreign countries are neither unprecedented in the tax area nor limited to state taxation. Some foreign countries have also complained about the new transfer pricing regulations promulgated by the I.R.S.[11] Just as the lack of complaints about a state tax department may suggest a passive administration that is not aggressively countering tax avoidance, the existence of complaints may simply be a healthy sign of a well functioning tax system. A fact-intensive inquiry into the nature and motivation underlying the complaints paraded by the Petitioners is necessary before the Court can give them any significance for purposes of a dormant foreign commerce clause analysis.

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[9] See Barclays International, A World of Banking – List of Offices November 1977 (1977) 4-5.

These countries are all described as tax havens in either Anthony S. Ginsberg, Tax Havens (1991), or Hoyt L. Barber, Tax Havens: How to Bank, Invest, and Do Business – Offshore and Tax Free (1993).

[10] See Letter from Barclays to British Inland Revenue of April 14, 1986 (Tr. record, Ex. 51-V).

[11] See OECD Committee on Fiscal Affairs, *Intercompany Transfer Pricing Regulations Under U.S. Section 482 – Temporary and Proposed Regulations* (1993). Complaints by foreign governments may be raised as a courtesy to major taxpayers or industries or they may be initiated by the country itself. Most developed countries provide a credit to their taxpayers for income taxes paid to other jurisdictions. A country providing a credit has a financial stake in minimizing the tax burden imposed by other countries, especially if these other countries are not viewed as competing with it for investment.

2. No Weight Should be Given to the United Kingdom's Threats to Violate International Law

Complaints by the United Kingdom against WWCR are mentioned prominently by Petitioner Barclays because of the form in which they are embodied. The United Kingdom has threatened to deny certain benefits (the advance corporation tax, "ACT", credit) to corporations that have significant activity in a state using WWCR. The United Kingdom adopted enabling legislation in 1985,[12] but the Parliament had to give its specific approval before the retaliatory legislation could be triggered.

In 1986, British officials stated that they had not triggered the retaliatory legislation on the understanding that the United States would enact legislation abolishing WWCR before the end of the year.[13] The threat of "retaliation" was repeated two more times in 1986.[14] The threat was made again in 1988[15] and in 1993.[16] With the passage of California's legislation in 1993, discussed below, the threat has substantially been withdrawn.

These threats are the height of lawlessness and hypocrisy. In Article 10 of the U.S.-U.K. Tax Treaty, the United Kingdom agreed to provide the very ACT credits that it subsequently turned around and threatened to hold hostage in the political battle over WWCR.

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[12] Section 54 of the Finance Act of 1985, reenacted as §§ 812-815 of the Income and Corporations Taxes Act, 1988 (United Kingdom); Stephen E. Fiamma, *U.K. Retaliation Against Unitary Taxation*, 28 Tax Notes 1137 (September 2, 1985).

[13] *British MPs United in Worldwide Unitary Method Retaliation Efforts*, 31 Tax Notes 439 (May 5, 1986).

[14] Clive Holman, *MPs Threaten Retaliation Against US Unitary Tax*, Financial Times 6 (June 19, 1986); *Calling Britain's Bluff*, 300 The Economist 65 (August 2, 1986).

[15] *Retaliatory Motion to Unitary Method Introduced in Parliament*, 38 Tax Notes 592 (February 8, 1988).

[16] Sir Michael Grylls, MP, *UK Must Retaliate on CA Tax*, Financial Times 16 (May 6, 1993).

Further, its threats to violate international law[17] are in protest of WWCR, the very issue over which it received concessions during the negotiations over the treaty.[18] Such lawless action cannot be the type of justifiable retaliation by a foreign government that the Court was concerned about in *Container*. *Id.* at 194.

Apparently, the Congress agrees. The Congress has shown no interest either in counting the noses of those who have chimed in against WWCR or in genuflecting in the face of threats to violate international law.[19] Perhaps the Congress appreciates that as the economies of the world become more interlinked, state actions will inevitably raise some foreign protests. Some complaints are to be taken more seriously than others. As *Container* recognized, the nuances of U.S. foreign policy are much more the province of the Executive Branch and Congress than of this Court. *Id.* at 196. Despite complaints, Congress has refused for over twenty-five years to prohibit WWCR.[20] The Court should not now substitute its voice for that of the Congress.

[17] There is no doubt that if the United Kingdom were to deny the ACT credits, the treaty would be violated. In describing the retaliatory legislation, Assistant Secretary (Tax Policy), J. Roger Mentz stated "its actual implementation would be a clear violation of the treaty." Hearing on Review of Unitary Method of Taxation, Before the Subcomm. on Taxation and Debt Management, Senate Committee on Finance, 81 (Statement of J. Roger Mentz, Asst. Secretary, Tax Policy) (September 29, 1986).

[18] Third Protocol to the 1975 Income Tax Convention with the United Kingdom of Great Britain and Northern Ireland, as Amended, Report of the Committee on Foreign Relations, United States Senate on Executive Q, 96th Cong. 1st Sess. at 46-7 (June 15, 1979).

[19] The United States could respond to a violation by the British of Article 10 of the treaty in numerous ways. The President could terminate the treaty; or, under domestic law, the President could double the U.S. tax rate on U.K. companies up to a maximum of 80%; or increase the effective tax rates on U.K. companies to equalize them with the U.K. tax rate on U.S. companies. See IRC §§ 891 and 896. All of these options are serious, which may explain why the U.K. has never implemented its threat.

[20] *See* Hearing on H.R. 5076 Before the House Comm. on Ways and Means, 96th Cong., 2d Session, at 293-95 (statement of John S. Nolan, Counsel, on Behalf of Confederation of British Industry and the British National Comm. of the Int'l Chamber of Commerce) (March 31, 1980) for a detailed history (through 1980) of congressional consideration of, hearings on, and non-enactment of legislation that would have preempted WWCR and/or state taxation of foreign source income as it is defined by the federal government. Legislation to prohibit WWCR was introduced continuously through the 1980s in both houses and hearings were held at regular intervals. See *Hearing*, *supra* note 17. Preemptive legislation has been introduced at least as recently as late 1991. See S.1775, H.R. 2913, 102d Cong. 1st Sess.

3. The Executive Branch Does Not Speak for the Legislative Branch

Turning from international complaints about WWCR to domestic complaints, Petitioners remind us that former officials of the Executive branch of the federal government have been upset with the elimination of the anti-WWCR clause from the U.S.-U.K. treaty almost from the day that it was signed. Both Petitioners cite actions and statements from former Executive branch officials expressing their hostility to WWCR. But the federal government is not monolithic.[21] The issue of WWCR is not one in which the Constitution has given the President exclusive power. Power over foreign commerce is shared. The Legislative branch has the Constitutional power to regulate foreign commerce, the President has the Constitutional power to sign or veto legislation passed by the Congress, and the Congress has the Constitutional power to override a Presidential veto. The President has the Constitutional power to enter into treaties with foreign nations that might regulate foreign commerce, and the Senate has the Constitutional power to advice and consent on such treaties. This Constitutional distribution of powers does not give the President the power to preempt a state tax provision through press releases or letters.

[21] The Court has never suggested that the views of the Executive branch were to carry more weight than the views of the Legislative branch. In its dormant foreign commerce clause discussion in *Container*, the Court consistently refers to the "federal government," "federal policy," "the Executive Branch and Congress" and so forth. See *Container*, 463 U.S. at 193-196. The disproportionate emphasis placed by the Petitioners on the views of the Executive branch may reflect the Court's reference in *Container* to the lack of an *amicus curiae* brief from the Executive branch. The failure of the Executive branch to file an *amicus curiae* brief would undercut a claim that WWCR interferes with federal uniformity. The filing of such a brief, however, is merely one factor to be considered by the Court in applying a dormant foreign commerce clause analysis. *Compare Itel*, 113 S.Ct. 1095 *with Container*, 463 U.S. 159.

Otherwise, the constitutionality of WWCR could change every four years and would "emphasize transient results upon policies . . . and lose sight of enduring consequences upon the balanced power structure of our Republic." *Youngstown Co. v. Sawyer*, 343 U.S. 579, 634 (Jackson, J., concurring) (1952). Such a result would be contrary to our deeply held tradition of being a country that ascribes to the "rule of law." Fortunately, the foreign dormant commerce clause does not require that absurdity.

Understandably, the Petitioners would like to ignore the posture of the Legislative branch, which has always refused to interfere with WWCR. The Senate made its position clear at the time of the U.S.-U.K. tax treaty: "political subdivisions and local authorities of either country are free to use formula methods to apportion income, deductions, and other items among related enterprises in determining income subject to their taxes, so long as such methods do not violate the proposed treaty's nondiscrimination provisions (Article 24)."[22] The House has also expressed its position by refusing to adopt for the past 20 years bills that have been introduced that would affect WWCR.[23]

After more than two decades of debate, the Legislative branch has still refused to curtail the use of WWCR. Uniformity can hardly be characterized as "essential" if it is still lacking after all this time. Accordingly, California's use of WWCR cannot "impair federal uniformity in an area where federal uniformity is essential." *Container*, 463 U.S. at 193 (citing *Japan Line*, 441 U.S. at 448).

Finally, even a decision for Petitioners would not result in the government speaking with one voice because the Congress has indicated not only that federal uniformity is not essential but also that WWCR is permitted. The Court has, in similar contexts, recognized its limitations in imposing solutions on

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[22] *Report, supra* note 18, at 5.

[23] See Brief for Petitioner Barclays at 9.

issues best left to the political process.[24] "It may be that 'the better part of both wisdom and valor is to respect the judgment of the other branches of the Government.' "[25]

Furthermore, California's use of WWCR is not necessarily at odds with the actions of the Reagan administration, which is the last administration to articulate a comprehensive position on WWCR. In 1983, the Reagan administration appointed a Cabinet level working group, consisting of government officials, business representatives, and ~~representatives of the~~ state governments, to study the issue.[26] The Working Group recommended that the states voluntarily adopt a water's edge limitation on combined reporting. Secretary of the Treasury Regan's final report indicated that the Group would support restrictive federal legislation if the issue was not solved within a year of the report. But if the "states enact legislation . . . agreed upon by the Working Group, the United States will be able to speak with one voice in dealing with its foreign trading partners . . . "[27]

California enacted water's edge legislation, but made it elective and imposed an election fee. This action appeased the Executive branch, which stated that "state legislative developments . . . go a long way toward resolving the difficult unitary tax issue" and "illustrate the successful operation of the

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[24] "The underlying [commerce clause issue] is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve." *Quill Corporation v. North Dakota*, 112 S. Ct. 1904, 1916 (1992). *Quill* involved another long-standing problem of state taxation: the sales taxation of mail order sales. Despite Congress' unwillingness to adopt a federal solution to this problem, the Court refused to impose its own solution, recognizing that "Congress has the power to protect interstate commerce from intolerable or even undesirable burdens." [citations omitted]. *Id.*

[25] *Quill*, 112 S.Ct. at 1916 (citing *Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 638 (1981) (White, J., concurring)).

[26] *New Unitary Approaches Mulled in Wake of Treasury Decision*, 21 Tax Notes 69-70 (October 3, 1983).

[27] Department of the Treasury, Office of the Secretary, Final Report of the Worldwide Unitary Taxation Working Group, iii (August, 1984).

Federal system."[28] The Executive branch pronounced "that restrictive Federal legislation is not warranted at this time."[29] Most recently, in 1993 California further amended its legislation, removing the election fee. California's current law satisfies the expectations of the Reagan administration.

With the election of President Clinton, the Executive branch may have shifted its voice. During the 1992 presidential campaign Governor Clinton stated " . . . a Clinton Administration will be pro-California in [the *Barclay's*] litigation."[30] Consistent with this position, the Solicitor General opposed the grant of *certiorari* in *Barclays*, citing California's recent legislative changes modifying WWCR for concluding that "[a] decision by this Court on the constitutional question posed in this case is . . . unnecessary to achieve adequate consistency in the Nation's regulation of foreign commerce, which California has striven to accomplish through its voluntary action." Brief of Solicitor General on Petition for *Writ of Certiorari* at 10. The Solicitor General also made it clear that federal uniformity is no longer essential. There has now been an "accommodation of state, national, and international interests," *id.* at 10. As of 1994, it appears that the voice of the Executive branch is more in harmony with the voice of the Legislative branch than at

[28] See *Hearing*, *supra* note 17 at 71.

[29] *Id.*

[30] John Turro, *Clinton Administration Expected to Support California in Barclays Bank Unitary Case*, 4 State Tax Notes 717-718 (March 29, 1993). This position was consistent with the President's promise to collect $45 billion of additional tax revenue over four years by "cracking down on foreign companies that prosper here and manipulate tax laws to their advantage." Governor Bill Clinton, *Putting People First: A National Economic Strategy for America*, 4, 22 (1992). It was widely believed that this revenue loss was attributed to transfer pricing abuses. For example, a former Commissioner of the Internal Revenue Service testified that "foreign controlled companies have adopted transfer pricing and other practices that may significantly understate their U.S. income tax liabilities," and that the IRS believes "the shortfall is substantial," with the "U.S. Government . . . being short-changed billions of dollars annually." Tax Underpayments by U.S. Subsidiaries of Foreign Companies: Hearings before Subcomm. on Oversight of the House Comm. on Ways and Means, 100th Cong., 2d Sess., July 10, 12, 1990, pp. 72, 73 (Statement of Fred T. Goldberg, Commissioner of the IRS). Estimates of the annual federal revenue loss from transfer pricing abuses is as high as $30 billion. *Id.*, at 262 (Statement of Rep. J. J. Pickle).

any other time in the debate over WWCR. Also, the retaliatory threat of the United Kingdom to deny treaty benefits to U.S. corporations has subsided.[31]

C. No Unconstitutional Double Taxation Exists

Under *Japan Line*, a tax is constitutionally suspect if it inevitably results in double taxation. In *Japan Line*, the same property was taxed by both Japan and California, with no established means of mitigating the overlapping assertions of taxing jurisdiction. The meaning of objectionable double taxation was obvious in *Japan Line*: two taxes on the same property with no relief mechanism. In a world in which both national and subnational governments impose income taxes, and where a long-standing custom and pattern of relief mechanisms exist internationally, the concept of objectionable double taxation is less evident. The Court in *Container* appreciated the difference between property taxes and income taxes and properly dismissed the double taxation argument in that case. Because Petitioner Barclays attempts to reopen that argument, it is worthwhile to expand on why there is no objectionable double taxation in the present case.

As this Court has recognized, double taxation already exists in the purely domestic U.S. situation. In *Mobil Oil v. Vermont*, 445 U.S. 425, 448 (1980), the Court recognized that

> "[c]oncurrent federal and state taxation of income, of course, is a well-established norm. *Absent some explicit directive from Congress*, we cannot infer that treatment of foreign income at the federal level mandates identical treatment by the States." (Emphasis added).

A corporation's income is taxed by both the federal government and the states.[32] This type of double taxation is above constitutional challenge. In other federalist countries, such as Canada, this

[31] See Brief of the Government of the United Kingdom as *Amicus Curiae* in Support of Petitioner at 21-22.

[32] The double taxation from the concurrent taxation by the United States and the states is mitigated because state income taxes are deductible in calculating the federal income tax. A few states even allow a deduction for the federal income tax in calculating the state income tax. See Richard Pomp, *The Illogical Deduction for Income Taxes Paid to Other States*, 42 Tax Law Rev. 419 (1987); Jerome R.

same pattern of unobjectionable double taxation exists between the national government and the subnational governments.

When a corporation resident in one country (the country of residence) earns income from another country (the source country), problems of double taxation can arise if no relief mechanism is provided. But in the case of income taxes, that problem tends not to occur. The custom and international practice is that the country of residence assumes the responsibility for eliminating the double taxation.[33] Most countries discharge this responsibility by either exempting foreign income (or categories thereof) or by providing a credit for income taxes paid to the source country.[34]

> "The effect of the foreign tax credit is that when the foreign tax rate is lower than the United States rate . . . a tax is paid to the United States at a rate equal to the excess of the United States rate over the foreign rate. When the foreign rate equals or exceeds the United States rate, the credit cancels United States tax liability. In short, the credit generally operates to reduce the effective over-all rate of tax to the higher of the foreign or the United States rate *and double taxation is eliminated because, in effect, only one tax is paid at the higher of the two rates.*"[35]

The credit does not eliminate the double taxation that results from the concurrent taxation by a national government and its subnational governments. This type of double taxation is the norm and outside the goal of the credit, regardless of whether a subnational government is taxing more or less income than what the national government is taxing.

For example, suppose P, a corporation, earns $100 in the source country and pays an income tax to the source country of

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HELLERSTEIN AND WALTER J. HELLERSTEIN, STATE TAXATION I: CORPORATE INCOME AND FRANCHISE TAXES (1993), 7-10.

[33] See U.S. Model Tax Treaty, Art. 23; OECD Model Tax Treaty, Art. 23.

[34] Nearly one-third of the OECD countries exempt foreign dividends received from other OECD countries. The remainder provide a foreign tax credit. See OECD, TAXING PROFITS IN A GLOBAL ECONOMY: DOMESTIC AND INTERNATIONAL ISSUES at 63 (1991).

[35] ELIZABETH OWENS, THE FOREIGN TAX CREDIT 3 (1961) (emphasis added).

$20. Assume the country of residence also imposes a tax of $30 on this same income. Without the credit (or some other relief measure), double taxation would result because P would be paying two taxes on the same item of income. If the country of residence chooses to discharge its responsibility for relieving double taxation through the use of a credit, it would reduce the $30 of tax otherwise owed to it by the $20 paid by P to the country of source, for a net tax of $10. P pays the same amount of tax that it would have paid if all of the income had been earned in the country of residence. Any subnational income tax in the country of residence would be in addition to the national taxes – the same result that occurs in a purely domestic situation.

Double taxation might occur if a subnational government in the country of residence is taxing income that is also subject to tax by a subnational government in the source country. Without any relief, there would be one level of national tax, as in the preceding example, and two levels of subnational taxes. One way of dealing with this problem of double taxation by subnational governments, if it occurs, would be for the subnational government in the country of residence to provide a credit for the income tax of the subnational government in the country of source. The responsibility of relieving subnational double taxation, however, has been viewed as the proper responsibility of the national government, which can easily address the problem by simply extending its tax credit to include foreign subnational income taxes.[36]

Some countries, such as the United States, Canada, and the United Kingdom, have unilaterally adopted foreign tax credits that extend to subnational income taxes.[37] Other countries that might not have done so unilaterally might do so by treaty. The OECD Model Tax Treaty, for example, provides that if the country of residence chooses to relieve double taxation by a credit rather than

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[36] See *Container*, 463 U.S. at 191 n. 30.

[37] In the United States, see IRC Sec. 901(b) and Treas. Reg. § 1.901-2(g)(2); in Canada, see ITA, Sec. 126(7)(a),(b); in the United Kingdom, see ICTA of 1970, Sec. 498.

by exempting foreign income, the credit extends to subnational income taxes.[38]

Barclays is not disputing California's right to impose some kind of income tax. Barclays is therefore conceding that two legitimate levels of taxes can exist: the federal income tax and the state taxes. An objectionable double tax would occur only if California and a subnational U.K. government taxed the same income. But such double taxation cannot occur because subnational governments in the United Kingdom do not levy income taxes.[39] Even if such double taxation occurred, the responsibility for alleviating it would fall on the United Kingdom as the country of residence. The essence of Barclays' objections to WWCR reduces to the fact that it may pay more under that system than under the arm's length method. But that objection may speak more to weaknesses in the arm's length method than to defects in WWCR.[40]

Moreover, it is not inevitable that WWCR produces a higher tax than would arm's length or some alternative form of taxation. There are at least two situations in which a taxpayer will be better off under WWCR than under the U.S. rules. The first involves corporations operating at a loss. WWCR allows a taxpayer to include loss corporations that have no nexus with California to be included in the combined report of the unitary business. These losses will offset income of the other corporations. The result can be that less income enters the pre-apportionment tax base than would be true if California followed the federal rules.[41]

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[38] OECD Model Tax Treaty, Arts. 23B, 2(1).

[39] Andrew W. Dilnot & J.A. Kay, Tax Reform in the United Kingdom: The Recent Experience, in World Tax Reform, eds. M. Boskin and C. McLure (1990), 149-176.

[40] Residence countries that have chosen to address double taxation through the use of foreign tax credit often have complicated rules to prevent abuse or to further political goals. Complaints that Barclays might have about the British foreign tax credit are properly addressed to the British Inland Revenue and not this Court.

[41] To take a simple, straightforward example, consider a U.S. parent operating in California owning 100% of a foreign corporation, which operates abroad at a loss. Assume the U.S. parent has $100 of income and that the foreign subsidiary has $100 of losses. If the U.S. parent files a combined report with its foreign subsidiary,

Second, under WWCR the apportionment percentage of the California taxpayer will reflect the payroll, property, and sales of all the members of the unitary business. The apportionment percentage of a unitary business that includes foreign corporations will likely be lower than under a water's edge approach where only U.S. corporations could be included in the combined report. The lower percentage may more than offset the increase in the pre-apportionment tax base resulting from including profitable foreign corporations.[42] Accordingly, there is no systemic bias in WWCR one way or the other.[43]

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the $100 loss will offset the $100 gain and there will be no taxable income. By contrast under the federal rules, U.S. corporations cannot file consolidated returns with foreign corporations. The parent would be taxable by the United States on $100. If, however, the U.S. corporation were to operate abroad in the form of a branch, the foreign loss would be offset against its U.S. profits. Consequently, the choice between operating abroad as a branch or as a subsidiary has U.S. tax consequences. Under California's approach, however, the same amount of California tax would be due regardless of whether a branch or a subsidiary were used. The California method has the advantage of not making the tax a function of how a business is organized on paper. Put differently, the California fisc will not be affected by the form in which a business chooses to operate.

[42] To illustrate, consider a U.S. parent that owns 100% of a foreign corporation. Assume the U.S. parent has $100 of taxable income and that its subsidiary also has $100 of taxable income. If only the parent is taxable by California under a water's edge approach, assume its apportionment factor is 25%, so that it would apportion $25 to California (25% X $100). Assume further that if the foreign subsidiary were included in a combined report, the apportionment factor would decline to 5%. In a combined report, the corporation would apportion $10 to California (5% X $200). The increase in taxable income from $100 to $200 is more than offset by the decline in the apportionment percentage from 25% to 5%.

[43] Petitioner Barclays' assertion that the "underlying economic assumption [of WWCR is] that the activity of the worldwide unitary business is equally profitable in all jurisdictions," Petitioner Barclays' Brief at 24, has been rejected by this Court, as well as by scholars. See Container, 463 U.S. at 182-83; Jerome R. Hellerstein, *Federal Income Taxation of Multinationals: Replacement of Separate Accounting with Formulary Apportionment*, 60 Tax Notes 1131, at 1140-1141 (August 23, 1993); and Eric J. Coffill, *Differences in Productivity and Profitability: A Response to Allegations of the Misattribution of Income in the Application of California's Worldwide Unitary Method*, 5 Int'l Tax & Bus. Law. 246 (1987).

D. The Court Should Clarify that *Japan Line* does not Apply to Corporate Income Taxes

The globalization of the marketplace means that state tax systems will inevitably reach activities having international connections. As this case demonstrates, *Japan Line* invites endless quarrels between the states and the multinationals. If the Petitioners were to have their way, every complaint by a foreign country about a state tax can become a federal Constitutional issue. And such complaints can easily be orchestrated.

A principled distinction exists, however, between property taxes and income taxes. Unlike income taxes, there is no international custom or pattern requiring the country of residence to provide a credit for property taxes levied by other countries.[44] Moreover, Japan actually levied a property tax on the same containers that were taxed by California and did not provide a credit for foreign property taxes. *Japan Line*, 441 U.S. at 452. Consequently, double taxation existed in fact.

The recent decision in *Itel* suggests that the Court itself recognizes that *Japan Line* should not be applied if measures exist for relieving double taxation. In upholding Tennessee's sales tax on the proceeds from the lease of containers used in foreign commerce, the Court stated,

> "[f]urthermore, the foreign commerce clause cannot be interpreted to demand that a state refrain from taxing any business transaction that is also potentially subject to taxation by a foreign sovereign . . . [the Tennessee credit] reduces, if not eliminates, the risk of multiple international taxation . . . Absent a conflict with a 'consistent international practice [or] . . . federal policy,' *Container Corp.*, 463 U.S., at 190, the careful apportionment of a state tax on business transactions conducted

[44] The lack of a custom of relieving double taxation in the case of property taxes is not surprising; under the discarded "home port doctrine" there would not be multiple property taxes. Although the Court in *Japan Line* refused to rehabilitate the home port doctrine, 441 U.S. at 443, the result of the case is consistent with that doctrine.

> within state borders does not create the substantial risk of international multiple taxation that implicates foreign commerce clause concerns. . . . "

Itel, 113 S.Ct. at 1104.

The concerns the Court expressed about multiple taxation in *Japan Line* have long been addressed and remedied in the case of income taxes. At a minimum, *Japan Line* should be limited to situations of multiple taxation that the international community has not addressed.

E. *Itel* and *Wardair* Cast Doubt on the Continued Vitality of *Japan Line*

The reasoning of *Itel* and *Wardair* would have required a different outcome in *Japan Line*. *Japan Line* involved the Customs Convention on Containers, signed by both Japan and the United States. The relevant part of the Convention provided that " . . . containers temporarily imported are admitted free of 'all duties and taxes whatsoever chargeable by *reason of importation*.' " *Japan Line*, 441 U.S. at 452. In interpreting the same Convention, *Itel* makes it clear that the relevant inquiry is the reason a state imposes a tax and not the reason why the subject of the tax – the containers – are in the jurisdiction. *Itel*, 113 S. Ct. at 1100. The *Itel* Court held that the Convention prohibits only those taxes based on the act of importation itself. The Los Angeles property tax in *Japan Line* would presumably be upheld under this standard because it is not imposed on the act of importation nor is it any kind of import duty or custom duty.

Japan Line is also inconsistent with *Wardair*. In *Wardair*, the Court examined the Chicago Convention on International Civil Aviation, a Resolution by the International Civil Aviation Organization, and other bilateral agreements dealing with international aviation. None of these prohibited taxation of aviation fuel by political subdivisions, "an omission which must be understood as representing a policy choice by the contracting parties." *Wardair*, 477 U.S. at 11.

> "What all of this makes abundantly clear is that the federal government has not remained silent with

regard to the question of whether states should have the power to impose taxes on aviation fuel used by foreign carriers in international travel. By negative implication arising out of more than 70 agreements entered into since the Chicago convention, the United States has at least acquiesced in state taxation of fuel used by foreign carriers in international travel. . . . " *Id.* at 12.

By contrast, in *Japan Line* the Court characterized a convention authorizing an exemption only from duties and taxes chargeable by reason of importation, as "reflect[ing] a national policy to remove impediments to the use of containers . . . " *Japan Line*, 441 U.S. at 452. *Wardair* suggests that the Court in *Japan Line* should have inferred that the signatories had acquiesced in a property tax on containers.

From a broader perspective, *Japan Line* is an aberration. *Japan Line* was decided in 1979, just two years after the Court made clear in *Complete Auto* that it had abandoned any attempt at determining when a state tax interfered with national uniformity or imposed a direct burden on interstate commerce. Without much experience with the four tests in *Complete Auto*, perhaps the *Japan Line* Court was unwilling to abandon the old *Cooley*-type inquiries in the case of foreign commerce. The difficulty with that type of inquiry seemed to be recognized by 1983 when the Court in *Container* went to great lengths – properly so – to remove state income taxes from the *Japan Line* orbit. *Container* showed great sensitivity to the complexities that are resolved by the rational workings of WWCR. Dormant foreign commerce clause analysis is not rigorous enough to be used to annul basic taxing schemes such as WWCR. Subsequent experience with the *Complete Auto* tests should reassure the Court that the additional *Japan Line* tests are unnecessary in the case of income taxes.

II. PROHIBITING WWCR UNDER THE DORMANT FOREIGN COMMERCE CLAUSE WOULD UNDERCUT THE CONSTITUTIONAL PROTECTION OF FEDERALISM

This case presents a weak setting for the application of the dormant foreign commerce clause. The Court is not writing on a clean slate, as it has in other situations. See, e.g., *Kraft v. Iowa*, 112 S. Ct. 2365 (1992). The issue of WWCR comes to the Court with 25 years of history. In 1978, in the debate over the U.S.-U.K. tax treaty, Senator Church stated that "[f]or some ten years, Congress has been rejecting the type of limitation on the power of our State governments to tax which is incorporated in article 9(4) of the pending treaty."[45] He noted that "[t]he original purpose for the Senate's role in the treaty process was to protect the interests of the several States in treaty matters. The framers feared that to give the executive branch of the Federal Government free rein in the treaty process would enable the President to ride roughshod over the States. We may have waited a while to see that fear confirmed, but that is exactly what article 9(4) of this treaty does. It demonstrates that the fears of the framers of our Constitution were well founded."[46]

Senator Church's understanding of the constitutional structure of the government was expanded upon by the Court a few years later:

> "Apart from the limitation on federal authority inherent in the delegated nature of Congress' Article I powers, the principal means chosen by the Framers to ensure the role of the States in the federal system lies in the structure of the Federal Government itself. It is no novelty to observe that the composition of the Federal Government was designed in large part to protect the States from overreaching by Congress. [footnote omitted]. . . . " In short, the Framers chose to rely on a federal system in which special restraints on federal power

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[45] 124 Cong. Rec. Part 14, Senate pp. 18416. (June 22, 1978).

[46] *Id.* at 18417.

over the States inhered principally in the workings of the National Government itself, rather than in discrete limitations on the objects of federal authority. State sovereign interests, then, are more properly protected by procedural safeguards inherent in the structure of the federal system than by judicially created limitations on federal power. . . . we are convinced that the fundamental limitation that the constitutional scheme imposes on the Commerce Clause to protect the 'States as States' is one of process rather than one of result. . . . the principal and basic limit on the federal commerce power is that inherent in all congressional action – the built-in restraints that our system provides through state participation in federal government action. The political process ensures that laws that unduly burden the States will not be promulgated."

Garcia, 469 U.S. at 550-52, 554, 556 (1985).

To date, the political process has ensured that the federal government would not impose constraints on WWCR, thereby recognizing that the power of taxation is an essential and indisputable attribute of state sovereignty. The curtailment of WWCR has come from the voluntary action of the states at the encouragement of the Executive Branch. As the Solicitor General stated, an "accommodation of state, national, and international interests"[47] has now been reached. That accommodation was over two decades in the making and should not be upset by this Court under a dormant foreign commerce clause analysis.

Considerations of federalism also caution against destroying the diversity of experimentation in the field of state taxation. As Justice Brandeis wrote,

> "There must be power in the States and the Nation to remould, through experimentation, our economic practices and institutions to meet changing social and economic needs. . . . It is one of the happy incidents of the federal system that a single courageous State may, if its citizens choose, serve as a

[47] Brief of Solicitor General on Petition for *Writ of Certiorari* at 10.

> laboratory; and try novel social and economic experiments without risk to the rest of the country."

New State Ice Co. v. Liebman, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting). WWCR well illustrates Justice Brandeis' wisdom.

The states were forced early in this century to cope with the problem of taxing multijurisdictional activities; in response to this challenge, they designed formulary apportionment and combined reporting. As federal officials and their counterparts around the world are becoming increasingly disillusioned with the arm's length method, they are beginning to extol the virtues of WWCR. For example, at his confirmation hearings, the Undersecretary of the Treasury for International Affairs referred to formulary apportionment as the direction in which the world will have to move.[48] Indeed, WWCR has already been suggested for use by the United States, Canada, and Mexico in the taxation of corporations operating within the North American Free Trade Zone.[49] Examining the issue of formulary apportionment for use by the European Community, a person who would become Assistant Secretary of the Treasury wrote: "Formula apportionment provides a useful and fair approximation of geographic allocation of income. This approach helps to curb tax avoidance by making it difficult to shift income away from high-tax jurisdictions. Furthermore, if a Community-wide formula were adopted, then the potential for double taxation would be mitigated. Additionally, formula apportionment simplifies tax administration, because authorities no longer need to verify

[48] *Summers Says Formula Apportionment System Would Require Multilateral Move*, 52 BNA Daily Tax Report G-6 (March 19, 1993) at G-7. Summers earlier wrote that under the federal rules, multinational firms can move profits across borders by manipulating transfer prices and by altering their means of financing. "An alternative approach is to rely on formula apportionment, which obviates the need to locate a multinational's home country and eliminates the incentive to use transfer prices to manipulate tax liabilities." See Lawrence H. Summers, *Taxation in a Small World*, in Herbert Stein, ed, Tax Policy in the Twenty-First Century 64, at 69, 70, 71 (1988).

[49] McIntyre and McIntyre, Using NAFTA to Introduce Formulary Apportionment, 93 Tax Notes International 64-9 (April 5, 1993).

the transfer prices involved in separate accounting, a time-consuming and difficult process."[50]

At a recent international conference involving tax officials, academics, lawyers and OECD representatives, formulary apportionment was acknowledged as having a bad reputation, largely because of political reasons.[51] This same group of tax experts concluded that the " arm's length principle and formulary apportionment should not be seen as polar extremes . . . it is not clear where the arm's length principle ceases and formulary apportionment begins."[52] Indeed, in one of the ultimate ironies in this case, it has been reported that Barclays negotiated a transfer pricing agreement with the IRS based on formulary apportionment.[53] IRS officials have confirmed that they have completed an "advanced pricing agreement" with a foreign bank based on a three-factor formulary apportionment method employed on a worldwide basis.[54] Paradoxically, at a time when federal officials are looking to

[50] Alicia H. Munnell, *Taxation of Capital Income in a Global Economy: An Overview*, NEW ENGLAND ECONOMIC REVIEW 33, at 46 (September/October 1992). This article was written when Assistant Secretary of the Treasury for Economic Affairs Alicia H. Munnell was Senior Vice President and Director of Research for the Federal Reserve Bank of Boston. Her views are consistent with other scholars. See, for example, McIntyre, Harmonizing Direct Taxes in the EEC, 2 TAX NOTES INT'L 131 (1990); McIntyre, Harmonizing Direct Taxes on Business within the EEC, 2 TAX NOTES INT'L 341 (1990).

[51] Brian J. Arnold and Thomas E. McDonnell, *Report on the Invitational Conference on Transfer Pricing: The Allocation of Income and Expenses Among Countries*, 61 TAX NOTES 1377, at 1381(December 13, 1993).

[52] *Id.*

[53] John Turro, *IRS Grants Two APAs in Derivative Products Areas*, 4 TAX NOTES INT'L 959 (May 11, 1992); Gerald C. Shea, *APAs May Effectively Address Income and Expense Allocation Problems Faced by Global Trading Businesses*, 4 TAX NOTES INT'L 1022 (May 18, 1992).

[54] Case example 2 in an Internal Revenue Service report on the Advanced Pricing Agreement program is "a U.S. branch of a foreign bank. The APA applied a *formulary allocation* of the net trading *profits* of the participants from their trading of derivative products on an integrated *worldwide basis*. The APA used a methodology with a *weighted three factor approach*." *See:* Robert Ackerman, et al., *The Advance Pricing Agreement (APA) Program: A Model Alternative Dispute Resolution Process*, 12 BNA DAILY REPORT FOR EXECUTIVES L-1 (January 19, 1994), at L-4

WWCR as part of a solution to the dilemma of arm's length pricing, the states have succumbed to political pressures and have retrenched.

The current emphasis on reinventing government has led to a new appreciation of the contributions and impact the states have had on federal policies. The experience of the states with WWCR has helped expose the practical inefficiencies and limitations with the arm's length approach and has irrevocably altered the debate over transfer pricing issues.

Out of necessity, the states have built a better mousetrap than the federal government. This mousetrap cannot be avoided by mergers and acquisitions, reorganizations, by how a business is organized on paper, or by where incorporation papers are filed, or by the setting of artificial prices in transactions between related parties. The mousetrap catches those who would use tax havens, such as Bermuda, the Cayman Islands, the Isle of Man, Nauru, the Turks and Caicos, or the Virgin Islands. The mice that get caught will squeak – and they may even get their friends to squeak and make empty threats. But these complaints cannot rise to the level of Constitutional significance without the anomalous result that the better the mousetrap, the greater the chance that the courts will release the mice.

The multinational community has led a relentless political campaign against WWCR. These efforts have forced the states to adopt voluntary limits on WWCR. Not content with this political victory, Petitioners are asking this Court to seal the laboratory doors shut so that no state could ever resurrect the method again. In an era of diminishing resources, the states need the freedom to deal with ever more complex international transactions. If the state laboratories are to be permanently closed, there should be more compelling reasons than those presented by the Petitioners.

(emphasis added). (The authors are identified as staff members of the APA Program in the IRS Office of the Associate Chief Counsel (International)). *Id.*, at L-1.

CONCLUSION

For the reasons stated above, Amicus Multistate Tax Commission urges the Court to affirm the decisions below.

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